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# In the Supreme Court

OF THE

# United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER COMPANY,
*Petitioner*

vs.

UNITED STATES OF AMERICA,
*Respondent.*

**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT**

## BRIEF FOR THE CHARLES SCHWAB CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER.

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## BRIEF FOR THE CHARLES SCHWAB CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER.

Pursuant to Rule 37.3 of the Rules of this Court, this brief is respectfully submitted in support of Petitioner by amicus curiae The Charles Schwab Corporation. The parties have consented to the filing of this brief, and their written consents have been filed with the clerk of this Court.

## INTEREST OF THE AMICUS CURIAE

The Charles Schwab Corporation is the owner of Charles Schwab & Co., Inc. (hereinafter referred to as "Schwab & Co."), America's largest discount broker. Schwab & Co. has grown from a single San Francisco office in 1974 to over 160 locations throughout the United States. Schwab & Co. serves more than 1.7 million active customer accounts. The growth in customer accounts has come from, in part, acquisition of other discount

brokerage companies or of customer accounts from other brokerages.

In 1981 and 1982, Schwab & Co. made six such acquisitions and claimed depreciation expense deductions for federal income tax purposes regarding the intangible assets it acquired, including customer accounts. This treatment was agreed to by the Internal Revenue Service ("IRS") during audits of Schwab & Co.'s tax returns. Schwab & Co. has relied upon its IRS audit experience and upon 20 years of case law regarding amortization of intangibles in negotiating more recent acquisitions, including the purchase of the entire company in 1987 from BankAmerica Corporation by Charles R. Schwab and a group of employees and other investors. The purchase in 1987 is presently the subject of a petition by The Charles Schwab Corporation to the United States Tax Court in a case in which the government is disputing the depreciation of the acquired intangibles.

## INTRODUCTION AND SUMMARY OF ARGUMENT

The Internal Revenue Code and the government's Treasury Regulations require depreciation of wasting assets, including intangibles. The regulations prohibit depreciation of "goodwill," but do not, on their face, define "goodwill." When the Treasury adopted the regulations, however, it incorporated, by reference, the definition that "goodwill" is the residuum remaining after subtraction of all assets capable of being transferred separately from an entire business. This rule was derived directly from the decisions of this Court in *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436 (1893), and of the Eighth Circuit Court of Appeals in *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927). "Goodwill" has this same meaning in normal commercial practice, as evidenced by generally accepted accounting standards.

In the decision below, *Newark Morning Ledger Co. v. United States*, 945 F.2d 555 (3d Cir. 1991), the Third Circuit ignored *Metropolitan Bank* altogether and paid only cursory attention to *Red Wing Malting Co.* Armed, in consequence, with an incomplete definition, the Third Circuit erroneously concluded that a



separately transferable asset — a subscriber list — constituted goodwill.

In its defense of the Third Circuit, the government argues, in essence, that when it says in its regulations that "goodwill" may not be depreciated, it means to deny depreciation not only to "goodwill", as defined in *Metropolitan Bank* and *Red Wing Malting Co.*, or as used in normal commercial practice, but also to intangibles that can be separately sold. The taxpayer, on the other hand, seeks only to depreciate the subscriber list that it acquired, but not its purchased goodwill.

The government has attempted to justify its position by citing incomplete definitions of the term "goodwill" in or from several cases. However, the government's redefinition of goodwill is not consistent with the definition of the term by this Court, as incorporated by the government into the Treasury Regulations here at issue, readopted in recent Treasury Regulations in another context, and reflected in normal commercial usage.

This Court should hold the government to the definition of "goodwill" the government has already adopted and, in consequence, reverse the Third Circuit and find in favor of the petitioner in this case.

## ARGUMENT

### I

### THE GOVERNMENT HAS ADOPTED, AND HAS RECENTLY CONFIRMED, BY VALIDLY PROMULGATED REGULATIONS, THE "RESIDUAL" DEFINITION OF GOODWILL ENUNCIATED BY THIS COURT AND APPLIED BY LOWER COURTS TO FEDERAL INCOME TAX CASES.

#### A. The Treasury Adopted The Residual Definition Of Goodwill When It Promulgated The Precursor Of Treasury Regulations Section 1.167(a)-3.

The central feature of this case is the proper interpretation of the italicized sentence of Treasury Regulations Section 1.167(a)-3 shown below:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. *No deduction for depreciation is allowable with respect to goodwill.* [Emphasis added.]

This iteration of the rule that goodwill is not subject to depreciation was adopted by the government, in substantially the foregoing form, in Treasury Decision 4055, VI-2 C.B. 63 (1927), based upon the decision of the Eighth Circuit Court of Appeals in *Red Wing Malting Co. v. Willcuts*, 15 F.2d 626 (8th Cir. 1926), *cert. denied*, 273 U.S. 763 (1927):

> In view of the decision of the Circuit Court of Appeals for the Eighth Circuit, in *Red Wing Malting Co. v. Willcuts, Collector*, dated November 5, 1926 [C.B. VI-1, 225], articles 163 of Regulations 45 (1920 edition), 62, 65, and 69 are hereby amended by the addition thereto of the provision that: "No deduction for depreciation, including obsolescence, is allowable in respect of goodwill." Said articles, as amended, read as follows:
>
> Art. 163. Depreciation of intangible property.—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. No deduction for depreciation, including obsolescence, is allowable in respect of goodwill.[1]



In promulgating Treasury Decision 4055, the government adopted, and is bound by,[2] the rule of *Red Wing Malting Co.* It must follow, since the Treasury Decision was without qualification in this regard, that the adoption was of the whole rule of *Red Wing Malting Co.* More specifically, in *Red Wing Malting Co.*, the court addressed two issues. One was the issue of whether goodwill is depreciable. The other was the definition of goodwill. It would make little sense to announce that depreciation may not be claimed as to "goodwill" without also having or prescribing an understanding of what the "goodwill" is that may not be depreciated. The court in *Red Wing Malting Co.* drew its conclusion that goodwill is nondepreciable from an extended analysis of the

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[1] T.D. 4055. This Regulation has been re-promulgated, with (so far as relevant here) minor language changes, several times to reflect reenactment of, or other changes in, the internal revenue laws. Former Reg. 111, § 29.23(l)-3; Former Reg. 118, § 39.23(l)-3; T.D. 6182, 1956 C.B. (Pt. 1) 98; T.D. 6452, 1960-1 C.B. 127. The government has not made material amendments to Treasury Regulation Section 1.167(a)-3 since 1927. That Regulation, therefore, means today what it meant then.

[2] It is beyond question that federal agencies are bound by their own rules. *Morton v. Ruiz*, 415 U.S. 199, 235 (1974); *Fribourg Navigation Co. v. Commissioner*, 383 U.S. 272, 279-280 (1966) (Commissioner's position in litigation was contrary to long-standing administrative and judicial practice); *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110, 115 (1939) (Commissioner conceded that he was bound "to apply the statute in conformity to the regulation," but argued that subsequent amendment to the regulation had retroactive effect). Further, while the government is free to amend its regulations, it is not free to disregard them, and cannot change the regulation by administrative pronouncement short of a regulation. *R.J. Reynolds Tobacco Co.; Honeywell Inc. v. Commissioner*, 87 T.C. 624, 635 (1986) (Revenue Ruling that was inconsistent with the regulation was of no effect); *Woods Investment Co. v. Commissioner*, 85 T.C. 274, 282 (1985) (Commissioner's reluctance to amend its own regulation did not justify creating a judicial exception).

nature and definition of goodwill. By basing the amended regulation upon *Red Wing Malting Co.*, the Treasury adopted the same analysis and definition.

**B. The Definition Of Goodwill, Based Upon This Court's Decision In *Metropolitan Bank* And Upon *Red Wing Malting Co.*, Is That Goodwill Is The Residuum After All Other Assets Have Been Identified.**

How, then, did *Red Wing Malting Co.*, and by adopting the rule of that case, the government, define "goodwill?" The definition is in two parts, derived principally from the decision of this Court in *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436 (1893). One part of the definition is that "goodwill" is

> " 'the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices.' Story, Part. § 99" [*Red Wing Malting Co.*, 15 F.2d at 632, quoting *Metropolitan Bank*, 149 U.S. at 446, quoting Joseph Story, *Commentaries on the Law of Partnership* § 99, 157 (Boston, Little, Brown and Co., 4th Ed., 1855).]

The other part of the definition, more significant for present purposes in that it unequivocally resolves the issue in the present case in favor of petitioner, is that goodwill is not a separately identifiable or transferable asset, but is merely an incident of a going concern:

> Goodwill is property of an intangible nature. It differs from such intangibles as patents, copyrights, licenses, and franchises, because, while in a certain sense it inheres in and is used in the business, it is not subject to depreciation, as that term is commonly understood and commonly used in the statutes. The Supreme Court of the United States in



*Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436, 446 [parallel cites omitted] says:

> "Undoubtedly, goodwill is in many cases a valuable thing, although there is difficulty in deciding accurately what is included under the term. It is tangible only as an incident, as connected with a going concern or business having locality or name, and is not susceptible of being disposed of independently . . . "[1]
>
> . . .
>
> We have heretofore pointed out that goodwill has no existence separate and apart from an established business. With the termination of that business it is ended. While a capital asset, it is not the subject of purchase, sale or assignment separate from the business itself. It is not an assignable asset distinct from the business. It is different in this respect from such intangibles as patents, contracts or franchises which may be sold. [*Red Wing Malting Co.*, 15 F.2d at 632-33.]

The direct corollary of this definition, to which the government is bound, is that "goodwill" is simply the otherwise unnamed residuum after subtraction of all assets capable of being purchased, sold, or assigned separate from the business itself. This conclusion follows from the re-iteration in the definition that goodwill

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[1] This Court, or the Eighth Circuit, could have cited the following passage from Story for this proposition as well:

> [Goodwill] is certainly not a visible, tangible interest, or a commodity, upon which a definite or fixed allowance can be made; nor, perhaps, would a contract, touching the conveyance thereof, be decreed to be specifically performed in equity. It is not, therefore, strictly speaking, a part of the partnership effects, of which, upon a dissolution thereof, a division can be compelled, unless, indeed, in cases, where a sale of the whole premises and stock will be ordered; and then the good-will will accompany such sale.

Story, *supra*, at 157-58 (footnote omitted).

> is not the subject of purchase, sale or assignment separate from the business. It is not an assignable asset distinct from the business.

The logically inescapable converse is that an asset that can be purchased, sold, or assigned "distinct from the business" is not goodwill. Under this definition, it is irrelevant whether an asset actually is transferred as part of a going business; the asset is not goodwill if it *could* be transferred separate from the business. This proposition follows from the plain language of the definition itself and is supported by the examples given by the court in *Red Wing Malting Co.* of assets that are separately salable — "such intangibles as patents, contracts or franchises." "Such intangibles" are simply not goodwill, and it makes no difference to their status whether they are sold separately or as part of the sale of a going concern.

There is no question that subscriber lists or customer accounts are capable of being purchased, sold, or assigned separate from the business that produced them. These are, therefore, not goodwill within the meaning of *Red Wing Malting Co.* and the government's Treasury Regulations. The association of an asset with "the expectation of continued patronage" is not sufficient to result in its classification as non-depreciable "goodwill." This expectation inheres in many assets: a patented formulation of a popular product, an advantageously located store, a long-term customer contract, attractively decorated premises. Nor is the fact that an intangible asset will produce income and is valued in part based on that income sufficient to result in classification as "goodwill." Business assets generally have value only because of the future income they are expected to produce, and the discounted present value of that future income fixes the worth of the asset.[4] It is only when the element of value under examination is

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[4]A discrepancy between valuation based upon the cost of reproduction and valuation using an income forecast methodology may require closer analysis to determine whether the same assets were valued in each case and whether the valuation techniques were properly applied. *See, e.g.*, Gordon V. Smith & Russell L. Parr, *Valuation of Intellectual Property and Intangible Assets* 144, 244 (New York, John Wiley & Sons, 1989). In the case below the government appears to have generated a low "cost" number by valuing the wrong asset. However, valuation remains, in all events, an issue of fact for the trier of fact.



not separately transferable apart from the business as a whole that it falls within the definition of goodwill enunciated by this Court, confirmed in *Red Wing Malting Co.*, adopted by the Treasury Regulations and, as discussed below, confirmed in later pronouncements by other courts.[5]

### C. The Government Has, By Subsequent Regulation, Confirmed Its Adoption Of The Residual Definition Of Goodwill.

In Temporary Treasury Regulations Section 1.367(a)-1T(d)(5)(iii), published in 1986 in Treasury Decision 8087, 1986-1 C.B. 175, the government re-committed itself to the residual definition of goodwill. For purposes of establishing the federal income tax consequences of transfers of property to and among foreign corporations, this regulation defines foreign goodwill as follows:

> Foreign goodwill or going concern value is the residual value of a business operation conducted outside the United States after all other tangible and intangible assets have been identified and valued.

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[5]This formulation is not inconsistent with *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463 (1986), *aff'd per curiam*, 919 F.2d 1492 (11th Cir. 1990). The government there argued that a deposit base was goodwill in part because it only had economic significance in the context of a transfer of assets from a bank to a bank. The Tax Court, relying on *Laird v. United States*, 556 F.2d 1224 (5th Cir. 1977), a case involving football player contracts, held that the association of deposit base with the remainder of a bank's business so that it cannot be separately sold except in the special context of bank-to-bank transfers did not result in its classification as goodwill. While the Tax Court stated that "separate transferability" of a deposit base was not required to establish that it is not goodwill, *Citizens & Southern Corp.*, 91 T.C. at 492-493, because of the reference to football player contracts (which are frequently separately transferred) and the undisputed evidence of actual transfers of deposit liabilities of failing banks in *Citizens & Southern Corp.*, it is clear that the court was merely rebutting the government's "mass asset" argument.

Thus, although the government's argument in this case ignores the existence of the residual definition of goodwill, that definition not only exists, but has been adopted and re-adopted by the government itself.

### D. The Residual Definition Of Goodwill Is Supported By Substantial Case Law.

A substantial number of cases, including *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), adopt or are consistent with the residual definition of goodwill.

#### 1. Cases Preceding *Houston Chronicle* Adopt The Residual Definition.

The following cases have adopted the residual definition of goodwill in the same manner that *Red Wing Malting Co.* did — by finding that separately transferable assets are not goodwill. Thus, in *Manhattan Brewing Co. v. Commissioner*, 6 B.T.A. 952, 960-61 (1927), the court stated:

> The intangible property which the petitioner asserts is subject to obsolescence consists of goodwill, tradenames, and trade-marks. Such assets have value, but that value is so interwoven with the operation of the business, so much an inseparable part of the going concern to which they appertain, that the ascertainment of such value is difficult and their sale, except as component parts of a going business concern is all but impossible.

In *Joseph Garneau Co, Inc. v. Commissioner*, 8 B.T.A. 1041, 1044-45 (1927), the court stated:

> Goodwill, though constituting property, has no existence as an isolated or segregated capital asset. It is not tangible and does not exist, except as an incident of a going business. It is inherently part and parcel of a going and established business, and of tangible, physical property actively employed in business. It can not be separated from the business and property to which it is attached and be dealt with or disposed of separately. Its value is reflected in the value of the business and property of which it is an inseparable part, and can be realized only upon a sale of the business and property.



> It may be said to be nothing more than an element or factor of the business and property. [Citation omitted.]

In *Norwich Pharmacal Co. v. Commissioner*, 30 B.T.A. 326, 330 (1934), the court stated:

> Goodwill is not susceptible of being disposed of independently, that is, separate and apart from the business to which it attaches. *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U.S. 436, 446. "Goodwill is the favor which the management of a business wins from the public." It has no existence separate and apart from an established business, and it can not be the subject of a loss except on the termination of the business and the sale of the assets. [Citation omitted.]

In *Pfleghar Hardware Specialty Co. v. Blair*, 30 F.2d 614, 616-17 (2d Cir. 1929), the court stated:

> Goodwill has no existence except in connection with a going business; it cannot be separated from the going business to which it is incident.

To the same effect are *Grace Bros. v. Commissioner*, 173 F.2d 170, 175 (9th Cir. 1949) (quoting *Pfleghar Hardware Specialty Co.); MacDonald v. Commissioner*, 3 T.C. 720, 727 (1944) (quoting *Metropolitan Bank); J.W. Wells Lumber Co. Trust A v. Commissioner*, 44 B.T.A. 551, 558 (1941) ("Goodwill can not be disposed of as an asset independently of the business to which it relates," citing *Metropolitan Bank*); *California Vegetable Union v. Commissioner*, 23 B.T.A. 935, 939 (1931) ("Goodwill has no existence separate and apart from an established business," citing *Red Wing Malting Co.* and quoting from *Metropolitan Bank); Dick & Bros. Quincy Brewing Co. v. United States*, 67 Ct. Cl. 505 (1929), reprinted in VIII-1 C.B. 254, 256 (quoting *Metropolitan Bank, Red Wing Malting Co.*, and *Joseph Garneau Co.); Metropolitan Laundry Co. v. United States*, 100 F. Supp. 803, 806 (N.D. Cal. 1951) (goodwill is "a business asset which, it has been recognized, cannot be disposed of separately from the business itself," citing *Grace Bros.* and *Red Wing Malting Co.);* and *Terminal Co. v. United States*, 296 F. Supp. 1084, 1087 (D. Del. 1969) (quoting *Metropolitan Bank*).

### 2. *Houston Chronicle* Is Consistent With The Residual Definition.

Although *Houston Chronicle* did not enunciate the residual definition of goodwill, it nonetheless reached a result consistent with that definition by allowing depreciation of the subscriber lists before it. *Houston Chronicle*, 481 F.2d at 1251-52, held that depreciation of customer lists is proper

> if [the] taxpayer sustains his burden of proving that the lists (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy.

This test differs from the residual definition of goodwill only insofar as it requires a taxpayer to make a separate showing that an intangible's *value* is "separate and distinct from goodwill." As shown above, under the residual definition of goodwill as established by this Court and substantial federal income tax authority, an intangible *is* separate from goodwill if it is capable of being separately identified and transferred. Thereafter, a taxpayer should need only to show that the asset has an ascertainable value and a limited useful life. The difference between *Houston Chronicle's* test and the residual definition of goodwill is thus more a matter of emphasis than of substance.

## II

## COMMERCIAL USAGE, AS REFLECTED IN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, ADOPTS THE RESIDUAL DEFINITION OF GOODWILL.

The Eighth Circuit in *Red Wing Malting Co.*, 15 F.2d at 632-33, referred not only to *Metropolitan Bank* in formulating its definition of goodwill, but also to the "[o]pinions of expert accountants," finding them "not without value in considering the peculiar nature and status of goodwill in business."[6]

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[6] The Eighth Circuit quoted extensively in this regard from Robert H. Montgomery, *Auditing Theory and Practice* (The Ronald Press Co., 1921); William Arthur Chase, *Higher Accountancy Principles and Practice* (Chicago, LaSalle Extension University, 1911); and Henry R. Hatfield, *Modern Accounting* (New York, D. Appleton and Co., 1923).



Commercial usage, as reflected in modern accounting principles, remains significant in determining the continued vitality of the residual definition of goodwill. These principles *require* use of the residual definition. Opinion 16 of the Accounting Principles Board ("APB"),[7] entitled "Business Combinations," requires an acquiring corporation to allocate the purchase price of an acquired corporation among the identifiable assets of the acquired corporation, in an amount equal to the fair market values of those assets; any residuum of purchase price over the fair market values of the identifiable assets is recorded as "goodwill":

> An acquiring corporation should allocate the cost of an acquired company to the assets acquired and liabilities assumed.
>
> First, all identifiable assets acquired, either individually or by type, and liabilities assumed in a business combination, whether or not shown in the financial statements of the acquired company, should be assigned a portion of the cost of the acquired company, normally equal to their fair values at date of acquisition.
>
> Second, the excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets ac-

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[7] In 1926, when the Eighth Circuit decided *Red Wing Malting Co.*, accounting treatises and textbooks were the only authority for accounting standards. Today, accounting standards are set by the Financial Accounting Standards Board ("FASB"). The Securities and Exchange Commission ("SEC"), charged with prescribing "the methods to be followed in the preparation of reports, in the appraisal or valuation of assets or liabilities, [and] in the determination of depreciation and depletion" [Securities Exchange Act of 1934, § 13(b), 15 U.S.C. § 78m(b)(1)], essentially delegated this task to both the FASB and its predecessor, the APB. SEC Financial Reporting Release, § 101.

quired less liabilities assumed should be recorded as goodwill.

*Business Combinations*, Accounting Principles Board Opinion No. 16, ¶ 87 (2 Financial Accounting Standards Board, 1991).[8]

APB Opinion 17, "Intangible Assets", reiterates:

> An enterprise may acquire intangible assets from others or may develop them itself. Many kinds of intangible assets may be identified and given reasonably descriptive names, for example, patents, franchises, trademarks, and the like. Other types of intangible assets lack specific identifiability. Both identifiable and unidentifiable assets may be developed internally. Identifiable intangible assets may be acquired singly, as a part of group of assets, or as part of an entire enterprise, but unidentifiable assets cannot be acquired singly. *The excess of the cost of an acquired company over the sum of identifiable net assets, usually called goodwill, is the most common unidentifiable intangible asset.*

*Intangible Assets*, Accounting Principles Board Opinion No. 17, ¶ 1 (2 Financial Accounting Standards Board, 1991) (emphasis added).[9]

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[8]This methodology corresponds to that required in allocating the purchase price of a business among the assets acquired for federal income tax purposes. 26 U.S.C. § 1060; Temp. Treas. Reg. §§ 1.338(b)-2T(b)(2), 1.1060-1T(d); *R.M. Smith, Inc. v. Commissioner*, 591 F.2d 248 (3d Cir. 1979).

[9]The Tax Court, in *Staab v. Commissioner*, 20 T.C. 830, 840 (1953), adopted virtually the same definition:

> Good will may be defined by the following formula: Good will equals a-b, where "a" is capitalized earning power and "b" is the value of assets used in the business. Good will, then, is an intangible consisting of the excess earning power of a business. A normal earning power is expected of the business assets, and if the business has greater earnings, then the business may be said to have good will. This excess in earning power may be due to any one or more of several reasons, and usually this extra value exists only because the business is a going concern, being successful and profitable.



These accounting rules, adopted in August 1970, thus continue to embody the residual definition of goodwill enunciated by this Court in *Metropolitan Bank*, applied for federal income tax purposes by the Eighth Circuit in *Red Wing Malting Co.*, and adopted by the government, first in T.D. 4055 and most recently in Temporary Treasury Regulations Section 1.367(a)-IT(d)(5)(iii). If an asset—such as a subscriber list—is identifiable, it is not goodwill. If it is separately transferable, it is not goodwill.

## III

## THE COURT BELOW OVERLOOKED THE RESIDUAL DEFINITION OF GOODWILL ESTABLISHED BY *METROPOLITAN BANK*, *RED WING MALTING CO.*, AND TREASURY REGULATIONS, ERRONEOUSLY ADOPTING A RULE INCONSISTENT WITH THAT DEFINITION.

An intriguing feature of *Newark Morning Ledger Co. v. United States*, 945 F.2d 555 (3d Cir. 1990), is that, while it cited *Red Wing Malting Co.*, it unaccountably failed to discuss that case or otherwise take into account the substantial body of case law discussed above following the residual definition of goodwill enunciated by this Court in *Metropolitan Bank*.[10]

Instead, *Newark Morning Ledger* relied for its definition of goodwill upon lower court decisions that had themselves lost touch with the line of cases spearheaded by *Metropolitan Bank*. The Third Circuit thus defined goodwill

> as "the expectancy that old customers will resort to the old place," *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963), and as "the expectancy of continued patronage, for

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[10]This failure is perhaps particularly noteworthy, since the Third Circuit, in footnote 4 of *Newark Morning Ledger*, 945 F.2d at 559, acknowledged that the change in regulations effected by Treasury Decision 4055 "followed the decision in *Red Wing Malting Co.*," but then, in footnote 5, *id.*, complained that "neither Congress, the Treasury, nor the Service has seen fit to promulgate a uniform or coherent definition of the term [goodwill]."

whatever reason," *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962). [945 F.2d at 559.]

*Killian* relied for the quoted proposition solely upon *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897 (5th Cir. 1962), which in turn relied upon — not *Metropolitan Bank, Red Wing Malting Co.*, and the numerous federal income tax cases deriving therefrom — but *Didlake v. Roden Grocery Co.*, 49 So. 384 (Ala. 1909), a case involving an effort of the estate of a deceased partner to "set aside a sale of the partnership's assets to a corporation composed in part of the surviving partners." 49 So. at 385. Moreover, while the court in *Didlake* did recite the definition of goodwill quoted by *Killian*, 49 So. at 386, it also recited a form of the residual definition of goodwill, 49 So. at 387:

> the authorities are clear to the effect that if a business is sold out entirely, and nothing is said about good will, it goes with the property. This necessarily follows from the fact that good will cannot exist except in connection with the business.

*Killian* omitted this part of the definition.

*Boe* relied upon part of the definition of goodwill in *Grace Bros.*, but did not mention the important qualification noted by the court in that case that "[g]ood will has no existence except in connection with a going business; it cannot be separated from the going business to which it is incident." *Grace Bros.*, 173 F.2d at 175, quoting *Pfleghar Hardware Specialty Co.*, 30 F.2d at 616.[11]

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[11]The more extensive list of supporting authorities cited by the Third Circuit at 945 F.2d at 565-66 suffers from the same defect. For example, *Brooks v. Commissioner*, 36 T.C. 1128, 1133 (1961), relied solely upon *Watson v. Commissioner*, 35 T.C. 203 (1960), which relied in part upon *Horton v. Commissioner*, 13 T.C. 143, 148 (1949), which took *its* definition of goodwill from " 'Words and Phrases,' vol. 18, p. 351." *Watson* also relied upon a definition set forth by "Judge Cardozo in *In Re Brown*, 242 N.Y. 1, 150 N.E. 581 (1926)." 35 T.C. at 213. *Skilken v. Commissioner*, 420 F.2d 266, 270 (6th Cir. 1969), cites *Burke v. Canfield*, 121 F.2d 877, 880 (D.C. Cir. 1941), which relies upon *Washburn v. National Wall-Paper Co.*, 81 F. 17, 20 (2d Cir. 1897), which cites no authority, and makes a "cf" reference to *Metropolitan Bank*, 121 F.2d at 880, n. 2. *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 681 (5th Cir. 1971) cites *Killian, Nelson Weaver Realty Co., Boe*, and *Karan v. Commissioner*, 319 F.2d 303, 306 (7th Cir. 1963). *Karan* relies soley upon *Brooks*. A common thread in this "phalanx," 945 F.2d at 565, of cases is that they all, by one means or another, avoided the rule of *Metropolitan Bank* and *Red Wing Malting Co.* The definition of goodwill in the "mass asset" or "indivisible asset" cases similarly does not derive from either *Metropolitan Bank* or *Red Wing Malting Co.* For example, one of the lead "mass asset" cases, *Golden State Towel and Linen Service, Ltd. v. United States*, 373 F.2d 938 (Ct.Cl. 1967), relies primarily on *Thrifticheck Service Corporation v. Commissioner*, 287 F.2d 1 (2d Cir. 1961), *Danville Press, Inc. v. Commissioner*, 1 B.T.A. 1171 (1925), and *Boe*. Both *Thrifticheck* and *Danville Press* were failure of proof cases which do not set forth definitions of goodwill. *Golden State Towel* does go on to recite that goodwill equals expectancy of continued patronage equals customer lists, but cites no authority for the proposition other than *Michaels v. Commissioner*, 12 T.C. 17 (1949), which finds as a fact in the circumstances of that case that " 'Good will' and the customers' lists were substantially the same."



In short, *Newark Morning Ledger* armed itself with an incomplete definition of goodwill and, partly in consequence, reached an incorrect result. Had the Third Circuit reviewed the substantial line of cases derived from *Red Wing Malting Co.*, which it cited in connection with Treasury Regulations Section 1.167(a)-3 but apparently did not otherwise analyze, it should have reached the conclusion that a subscriber list, or any asset capable of being transferred separately and not merely as part of a going concern, is not goodwill and is depreciable upon a reasonable showing of value and useful life.

## IV

## THE GOVERNMENT'S ARGUMENT IN THIS CASE IS BASED UPON AN INCOMPLETE DEFINITION OF "GOODWILL."

In its Brief regarding the Petition for Writ of Certiorari in this case, the government, like the Third Circuit, relies upon a fatally incomplete definition of "goodwill." At page 10 of its Brief, the

government cites *Metropolitan Bank*, 149 U.S. at 446, but only for the proposition that

> Goodwill may be attributable to a business's location, its age, the superiority of its products or services and any other factor that blesses it with a favorable name and reputation, helping to attract "constant or habitual customers."

The government overlooks the rest of the definition of "goodwill" in *Metropolitan Bank*, *Red Wing Malting Co.*, the substantial body of federal income tax cases adopting the residual definition of goodwill, and its own regulations adopting the same definition.

In effect, the government is, by indirection, asking this Court to limit its decision in *Metropolitan Bank* and rescue the government from the consequences of having adopted the full *Metropolitan Bank* rule in its own regulations. If the government wants to expand its definition, it has the power to do so by amending its regulations according to regular administrative processes. It should not seek to do so in this forum.

## CONCLUSION

This Court's definition of goodwill in *Metropolitan Bank*, as adopted by *Red Wing Malting Co.*, by a substantial number of other cases, and by the government itself in its own Treasury Regulations, remains valid and should be adhered to. The decision below should be reversed in light of those authorities.

Respectfully submitted,

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